

Message Text

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ACTION EUR-12

INFO OCT-01 ISO-00 AID-05 CIAE-00 COME-00 EB-08 FRB-03
INR-10 NSAE-00 ICA-11 XMB-02 OPIC-03 SP-02 LAB-04
SIL-01 OMB-01 NSC-05 SS-15 STR-07 CEA-01 L-03
H-01 /095 W

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R 011410Z AUG 78
FM AMEMBASSY ROME
TO SECSTATE WASHDC 4591
TREASURY DEPT WASHDC

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5. FACTOS THAT HAVE DISCOURAGED A RAPID BUILD-UP OF STOCKS, BOTH OF FINISHED PRODUCTS AND RAW MATERIALS, DURING THIS EXPANSION PHASE OF THE CYCLE ARE: (1) THE WEAKNESS OF THE UPTURN IN DEMAND, (2) RELATIVELY GOOD PROSPECTS FOR A STABLE EXCHANGE RATE, (3) RELATIVELY STABLE RAW MATERIAL PRICES, AND (4) HIGH DOMESTIC INTEREST RATES. ADDITIONAL INFLUENCES (OF A MORE STRUCTURAL NATURE) THAT MAY BE DAMPING THE INVENTORY CYCLE IN ITALY, AND SO HELP EXPLAIN THE APPARENT LACK OF STOCK BUILDING DURING THE PRESENT UPTURN, ARE THE SHORTENING AND DAMPING OF THE ITALIAN BUSINESS CYCLE IN GENERAL AND THE HEIGHTNEED UNCERTAINTY CAUSED BY INFLATION AND THE STOP/GO ECONOMIC POLITICES OF RECENT YEARS.

6. EXTERNAL EQUILIBRIUM. THE CONTINUOUSLY POSITIVE TRADE BALANCES IN THE FIRST FIVE MONTHS OF 1978 SEEM SOMEWHAT INCONSISTENT WITH THE HIGHER LEVEL OF PRODUCTION AND NEW ORDERS CITED ABOVE. MONTHLY SURPLUSES (CUSTOMS BASIS, FOB/FOB) IN MILLIONS OF DOLLARS DURING JANUARY-MAY WERE 89, 162, 74, 325 AND 6. THESE TRADE SURPLUSES ARE ATTRIBUTABLE TO SLOW RATE OF IMPORTS ON A QUANTITY BASIS IN THE FIRST MONTHS OF THIS YEAR. THE DECLINE IN
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IMPORTS IS MOST MARKED IN COMPARISON WITH SHARP, SUPURTS IN IMPORTS IN THE FIRST PARTS OF 1977 AND 1976 BUT LESS SO IN COMPARISON WITH THE EVOLUTION OF IMPORTS IN 1974 AND 1975. THE CONTINUATION OF THE SLIGHTLY HIGHER

RATE OF INCREASE OF ITALIAN EXPORT PRICES RELATIVE TO IMPORT PRICES (ACTUALLY UNIT VALUE) HAS ALSO CONTRIBUTED TO THE SURPLUS ON TRADE. THE SATISFACTORY DEVELOPMENTS ON CURRENT AND CAPITAL ACCOUNT DURING JANUARY-JUNE THIS YEAR HAVE IN TURN BEEN ACCOMPANIED BY A STABLE LIRA AND AN INCREASE OF \$1.2 BILLION IN FOREIGN EXCHANGE RESERVES; DURING THIS PERIOD THE NET FOREIGN DEBTOR POSITION OF THE BANKS INCREASED BY \$460 MILLION, AND TOTAL OFFICIAL DEBT REPAYMENTS AMOUNTED TO \$1.7 BILLION. BALANCE OF PAYMENTS DEVELOPMENTS TOGETHER WITH THE SLOWING OF INFLATION HAS FAVORED THE NARROWING OF THE FORWARD DISCOUNT ON THE LIRA TO THE 5 PERCENT RANGE AT PRESENT FROM ABOUT 10-11 PERCENT IN JANUARY AND THE DECLINE IN ITALIAN INTEREST RATES FROM THEIR PEAK LEVELS IN 1977. THE COVERED DIFFERENTIAL BETWEEN ITALIAN AND INTERNATIONAL INTEREST RATES, HOWEVER, CONTINUES TO FAVOR BORROWING ABROAD.

7. GIVEN THE OUTLOOK FOR A GRADUAL PICKUP IN ECONOMIC ACTIVITY, THE TRADE BALANCE SHOULD CONTINUE IN SMALL SURPLUS ON AVERAGE FOR THE REST OF THE YEAR. THE USUAL SURPLUS IN THE SERVICES ACCOUNT WOULD THEN RESULT IN A FAIRLY SIZEABLE SURPLUS ON CURRENT ACCOUNT, ON THE ORDER OF \$3 BILLION FOR 1978 AS A WHOLE.

8. INFLATION. THE COST OF LIVING INDEX AVERAGED 12.8 PERCENT HIGHER IN THE FIRST HALF 1978 THAN IN THE SAME

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PERIOD 1977, A SIGNIFICANT DROP FROM THE 21 PERCENT

INCREASE IN FIRST HALF 1977 OVER FIRST HALF 1976. A
NUMBER OF FACTORS SHOULD FAVOR FURTHER PROGRESS IN
REDUCING INFLATION: RELATIVELY STABLE WORLD IMPORT
PRICES, TOGETHER WITH A STABLE LIRA/DOLLAR EXCHANGE RATE,
HAS HELPED BRING WHOLESAL PRICE INCREASES DOWN DRAMATICALLY:
THE WHOLESAL PRICE INDEX WENT ON AVERAGE ONLY 8.2 PERCENT
HIGHER IN FIRST SIX MONTHS OF THIS YEAR COMPARED TO SAME
PERIOD 1977. IN JANUARY-JUNE 1977 OVER 1976, WHOLESAL
PRICES WERE 23 PERCENT HIGHER. ESTIMATES INDICATE THAT
UNIT LABOR COST DECREASED A BIT IN THE FIRST QUARTER
1978 BECAUSE OF THE RISE IN PRODUCTIVITY ASSOCIATED WITH
THE RECOVERY: THE "FISCALIZATION" OF SOCIAL INSURANCE
BENEFITS HAS ALSO HELPED HOLD DOWN COST OF LABOR INCREASES.
NEVERTHELESS, 12-13 PERCENT A YEAR APPEARS TO BE A KIND
OF FLOOR AT PRESENT FOR INFLATION IN ITALY. MONTHLY
INCREASES IN THE COST OF LIVING INDEX ARE FLUCTUATING AROUND
1 PERCENT, AND EXPERT FORECASTERS GENERALLY FORESEE NO
FURTHER DECLINE. CAUSES FOR CONCERN ARE THAT THE
MAJOR ROUND OF LABOR CONTRACT RENEWALS THIS AUTUMN MAY
RESULT IN SUBSTANTIAL REAL WAGE INCREASES AND THAT
PUBLIC EXPENDITURES IS TOO HIGH AND WILL RESULT IN EXCESS
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LIQUIDITY CREATION AS THE BANK OF ITALY TRIES TO FINANCE IT.

9. PUBLIC FINANCE. THE GROWTH IN THE GOVERNMENT DEFICIT
HAS ACCELERATED IN 1978 THE DEFICIT (IN THE NARROW,
NOT ENLARGED, SENSE) IN THE FIRST SIX MONTHS OF THIS
YEAR ALREADY AMOUNTED TO ABOUT 70 PERCENT OF THE 1977
ENTIRE YEAR DEFICIT, THAT IS, 15,500 BILLION LIRE IN
JANUARY-JUNE 1978 COMPARED TO 22,500 BILLION LIRE IN
12 MONTHS 1977. THIS YEAR'S RAPID EXPANSION OF THE DEFICIT
IS ATTRIBUTABLE TO A SLOWING IN RECEIPTS AS WELL AS TO
AN INCREASE IN EXPENDITURES. IN PARTICULAR, PENSIONS
AND OTHER TRANSFER PAYMENTS HAVE INCREASED SHARPLY IN
THE CURRENT YEAR AS THESE BECAME FULLY INDEXED TO THE
COST OF LIVING. ANOTHER ADVERSE DEVELOPMENT IS THAT A
SIGNIFICANT AND GROWING PERCENTAGE OF THE 1978 DEFICIT
IS BEING FINANCED BY THE BANK OF ITALY THROUGH MONEY
CREATION, WHEREAS IN 1977 IT WAS ENTIRELY FINANCED THROUGH
TREASURY BILL SALES TO THE BANKS AND THE PUBLIC.

10. DEVELOPMENTS IN PUBLIC FINANCE DURING THE FIRST
HALF OF 1978 SHOW THE LACK OF ACTION ON CORRECTING THE
DISEQUILIBRIUM IN THE PUBLIC SECTOR. GIVEN THE NUMBER
OF MONTHS THAT ALREADY PASSED IN 1978 AND THE HIGH
PROBABILITY THAT CORRECTIVE ACTION WILL NOT BE TAKEN
UNTIL OCTOBER AT THE EARLIEST, PRESENT TRENDS IN
PUBLIC SPENDING AND IN THE PUBLIC DEFICIT WILL CONTINUE
AT LEAST WELL INTO 1979.

11. MONEY AND CREDIT.THE EXPANSION OF MONETARY BASE REMAINS TO DATE "UNDER CONTROL", FLUCTUATING IN THE RANGE OF 18-21 PERCENT A YEAR.INCREASING PRESSURE ON THE BANK OF ITALY, HOWEVER, TO COVER THE FINANCING NEEDS OF THE TREASURY, AS NOTED ABOVE, GIVES CAUSE FOR LIMITED OFFICIAL USE

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CONCRN REGARDING THE FUTURE EVOLUTTION OF "HIGH-POWERED MONEY" FURING THE FIRST FOUR MONTHS OF 1978, BANK OF ITALY FINANCING OF THE TREASURY ACCOUNTED FOR 92 PERCENT OF MONETARY BASE EXPANSION, AND THE OUTLOOK IS THAT THE FINANCING NEEDS OF THETREASURY WILL CONTINUE TO GROW WELL INTO 1979.

12. THE GROWTH OF MONETARY BASE HAS CAUSED THEMONETARY AGGREGATES (M1, M2, AND M3). TO EXPAND AT SOMEWHAT HIHER RATES IN 1978 THAN IN 1977, I.E., GROUND 3-24 PERCENT COMPARED TO 20-22 PERCENT. HE GROWTH OF TOAL DOMESTIC CREIDT OSCILLATED AROUND 18 PERCENT A YEAR DURING THE FIRST HALF 1978, ABOUT THE SAME AS IN 1977. THE STABILITY IN DOMESTIC CREDIT EXPANSION CAN BE ATTRIBUTED TO THE QUANTITITATIVE CEILINGS ON BANK LENDING.

13. INTEREST RATES DECLINED ON AVERAGE IN 1977 BECAUSE DEMAND FOR CREDIT FELL ALONG WITH THE LEVEL OF ECONOMIC AVTIVITY AND INFLATION EXPECTATIONS SUSIDED. TO ATE IN 1978 THERE HAS BEEN LITTLE FURTHER DROP IN INTEREST LEVELLED OFF AND EXPECTATIONS OFFURTHER DECLINES IN THE RATE OF INFLATION HAVE ATTENUATED. IN RUEAL TERMS, THAT IS AFTER TAING ACCOUNT OF AN ANTICIPATED RATE OF INFLATION OF ABUT 14 PERCENT, INTEREST RATES ARE QUITE LOW, EVEN NEGATIVE.

14. IT IS A VIEW WIDELY SHARED THAT THE FIRST CON-SEQUENCES OF THE GROWTH OF EXCESS LIQUIDITY IN ITALY ARE THE DETERIORATION OF THE BALANCE OF PAYMENTS AND THE DEPRECIATION OF THE EXCHANGE RATE: THE IMPACT OF DEPRECIATION ON INTERNAL PRICES THEN CAUSES INFLATION TO ACCELERATE. ALTHOUGH THE MONETARY AND CREDIT AGGREGATES STILL REMAIN "UNDER CONTROL," I.E., THEIR RATES OF GROWTH HAVE NOT YET MOVED OUT OF THE RANGE OF THEIR MEDKIUM-TERM HISTORICAL TRENDS, DEVELOPMENTS IN PUBLIC FINANCE DESCRIBED ABOUT PROMPT CONCERN REGARDING INTERNAL AND EXTERNAL LIMITED OFFICIAL USE

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STABILITY IN THE SHORT TO MEDIUM-TERM.HOLMES

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